Office of the Legislative Auditor

State of Montana

Report to the Legislature

December 1994

Financial-Compliance Audit

For the Fiscal Year Ended June 30, 1994

State Compensation Insurance Fund

Department of Administration

We issued an unqualified opinion on the financial statements of the State Fund and our report contains no recommendations.

Direct comments/inquiries to:
Office of the Legislative Auditor
Room 135, State Capitol
PO Box 201705
Helena MT 59620-1705

94-30

FINANCIAL-COMPLIANCE AUDITS

Financial-compliance audits are conducted by the Office of the Legislative Auditor to determine if an agency's financial operations are properly conducted, the financial reports are presented fairly, and the agency has complied with applicable laws and regulations which could have a significant financial impact. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States General Accounting Office. Financial-compliance audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

The Single Audit Act of 1984 and OMB Circular A-128 require the auditor to issue certain financial, internal control, and compliance reports regarding the state's federal financial assistance programs, including all findings of noncompliance and questioned costs. This individual agency audit report is not intended to comply with the Single Audit Act of 1984 or OMB Circular A-128 and is therefore not intended for distribution to federal grantor agencies. The Office of the Legislative Auditor issues a statewide biennial Single Audit Report which complies with the reporting requirements listed above. The Single Audit Report for the two fiscal years ended June 30, 1993 has been issued. Copies of the Single Audit Report can be obtained by contacting:

Office of the Legislative Auditor
Room 135 State Capitol
PO Box 201705
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STATE OF MONTANA

Office of the Legislative Auditor

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Operations and EDP Audit

JAMES GILLETT
Financial-Compliance Audit

JIM PELLEGRINI
Performance Audit

December 1994

To the Legislative Audit Committee
of the Montana State Legislature:

This is our financial-compliance audit report on the State Compensation Insurance Fund, Department of Administration, for the fiscal year ended June 30, 1994. We performed this annual audit of the State Fund in compliance with section 39-71-2361, MCA. We thank the State Fund president and his staff for their cooperation and assistance throughout the audit.

Respectfully submitted,

Scott A. Seacat
Legislative Auditor

Office of the Legislative Auditor

Financial-Compliance Audit
For the Fiscal Year Ended June 30, 1994

State Compensation Insurance Fund

Department of Administration

Members of the audit staff involved in this audit were: Brenda Bokovoy, John Fine, Geralyn Hoffman, Lorry Parriman, and Patti J. Robertson.

Table of Contents

State Compensation Insurance Fund Board of Directors and Executive Officers

Board Members		Term Expires
Rick Hill, Chairman	Helena	April 1997
Les Hirsch	Miles City	April 1995
Robert Holman	Kalispell	April 1995
Sandra D. Reiter	Billings	April 1997
James A. Brouelette	Stevensville	April 1997

Carl Swanson, President (effective January 3, 1994)

Patrick Sweeney, President (resigned December 31, 1993)

James Murphy, Executive Vice President (resigned December 31, 1993)

John King, Vice President, Underwriting Department

Mark Barry, Vice President, Administrative and Finance Department

Nancy Butler, General Counsel

Azmi Salaymeh, Vice President, Loss Control and Premium Audit Department

Jim McCluskey, Vice President, Claim Department

Joanne Shydian, Vice President, Human Resources

Judy Simpson, Vice President, Management Information System

Introduction

The State Compensation Insurance Fund (State Fund) was established by the 1989 Legislature to administer the state operated workers' compensation plan. Under state law, the Governor appoints five directors to set policy for the State Fund and hire a president to manage State Fund operations. The State Fund is attached to the Department of Administration for administrative purposes only. At June 30, 1994, the State Fund had 249.75 authorized full-time equivalent (FTE) positions.

We performed a financial-compliance audit of the State Fund for the fiscal year ended June 30, 1994, in accordance with section 39-71-2361, MCA. The objectives of the audit were to:

1. Determine State Fund's compliance with applicable laws and regulations.
2. Make recommendations for improvements in the management and internal accounting controls of the State Fund.
3. Determine if the financial statements present fairly the financial position, results of operations, and cash flows of the State Fund for the fiscal year ended June 30, 1994.
4. Determine the implementation status of prior audit recommendations.

Areas of concern deemed not to have a significant effect on the successful operations of the State Fund are not specifically included in the report, but have been discussed with management.

Actuarial Soundness

Section 39-71-2352, MCA, separates funding sources for claims incurred before July 1, 1990 (Old Fund) and those incurred on or after July 1, 1990 (New Fund). Premium rates are to be set to cover actuarially estimated costs for accidents which occurred on or after July 1, 1990. Premium revenue is no longer used to cover the liability and funding deficiency of claims incurred prior to that date. As a result, the term "actuarially sound" applies only to the New Fund for claims incurred on or after July 1, 1990. To be "actuarially sound" State Fund management

must set New Fund premium rates at amounts sufficient to recover present and future costs of all claims to maturity and to meet reasonable expenses of conducting the business of the State Fund.

The estimated claims liability at June 30, 1994, determined by the State Fund's consulting actuary, was $373,223,095 resulting in a New Fund surplus of $6.2 million. Effective July 1, 1993, state law requires rates established by the State Fund to include a provision to obtain, by July 1, 2003, a surplus of 25 percent of annual premium revenue.

Financing Past Claims Liability

At June 30, 1994, the State Fund's consulting actuary valued the remaining liability associated with claims incurred prior to July 1, 1990, at $339,485,647. During fiscal year 1993-94, State Fund paid claims and administrative costs of $28,374,339 and $2.9 million, respectively, related to Old Fund claims.

In October 1993, the State's Board of Investments (BOI) issued bonds for $32.5 million. Bond proceeds were used to repay $21,321,007 in loan principal and interest from the Old Fund to the New Fund and the remaining proceeds of $7,962,247, after issuance costs and debt service reserve, were pledged to meet Old Fund claims costs.

Section 39-71-2355, MCA, restricts the amount of bonds or New Fund loans that BOI may provide to the Old Fund. The section states, ". . . the board of investments may not give the State Fund loan proceeds or issue workers' compensation bonds unless the aggregate amount of outstanding and proposed loans and bonds can be serviced with no more than 90 percent of the amount of tax revenue that the department of revenue estimates will be raised by the tax imposed under section 39-71-2503, MCA, during the remainder of the then current fiscal year and during each succeeding fiscal year through the end of the fiscal year in which the last then outstanding or proposed loan or bond will be repaid or retired." Thus, BOI may not issue additional bonds or approve loans from the New Fund to the Old Fund unless the tax revenue is sufficient to make the required repayments.

The 1993 Legislature increased the employer Old Fund liability tax to .5 percent and added a .2 percent tax on employee wages effective July 1, 1993. The legislature also added a .2 percent tax on net income of self-employed persons for tax years beginning after December 31, 1993. This is intended to provide revenue for paying the debt and claims costs of the Old Fund.

Prior Audit Recommendations

Prior Audit Recommendations

As part of our audit, we reviewed the implementation status of recommendations in the prior State Fund audit for the fiscal year ended June 30, 1993. Our prior report included five recommendations. The State Fund implemented two and partially implemented three. The recommendations partially implemented relate to claim management and are discussed below. Since State Fund is in the process of implementing these prior audit recommendations we make no recommendations at this time.

Benefit Payments

In the prior audit report we recommended the State Fund establish procedures to ensure supervisors perform regular reviews of work performed by claim personnel. In July 1994, State Fund established new reserving and settlement procedures that will require periodic supervisor review during the individual claim life. Claim department management said State Fund claim supervisors no longer have a case load and are able to review files and give guidance/direction on claims handled by claim staff.

Case Reserves

In the prior audit report, we recommended the State Fund implement procedures to ensure claim department personnel establish case reserves in a timely manner after receipt of a claim. We also recommended claim supervisors review and approve case reserves and changes to reserves in accordance with State Fund policy. State Fund intends to purchase an automated case reserving system and anticipates this system to be operational in March of 1995. State Fund personnel also said they have established new reserving authority levels. This new policy was put into effect in July 1994.

Claims Policies and Procedures

In response to our prior audit recommendation related to claims policies and procedures, State Fund:

1. Implemented a Loss Prevention Alert process in April 1994 to provide loss prevention information to policy holders.

2. Started a project to develop and implement a performance evaluation system for all State Fund staff. The system will provide the means to identify and provide the training needed by the staff. The project will not be completed until spring 1995.

3. Hired a training coordinator in the claim department who has drafted a revised policies and procedures manual. The coordinator will be responsible for maintaining and updating the policies and procedures on a continual basis.

Independent Auditor's Report
& Agency Financial Statements

STATE OF MONTANA

Office of the Legislative Auditor

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Performance Audit

INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee
of the Montana State Legislature:

We have audited the financial statements of the Enterprise Funds of the State Compensation Insurance Fund, Old and New Funds, as of June 30, 1994, and for the fiscal year then ended as shown on pages A-5 through A-21. The information contained in these financial statements is the responsibility of State Compensation Insurance Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the State Compensation Insurance Fund, as of June 30, 1994, and the results of operations and the cash flows of its Enterprise Funds for the fiscal year then ended in conformity with generally accepted accounting principles.

Respectfully submitted,

James Gillett

James Gillett, CPA
Deputy Legislative Auditor

October 25, 1994

STATE COMPENSATION INSURANCE FUND
BALANCE SHEET - ENTERPRISE FUNDS
JUNE 30, 1994
(in thousands)

ASSETS:	New Fund	Old Fund
Cash in Treasury	$ 2,520	$ 1,404
Short-Term Investment Pool (note 1)	36,803	3,011
Acccounts Receivable (note 1)	56,255	987
Allowance for Doubtful Accounts	(801)	(618)
Due From Other Funds	1,351	17,985
Interest Receivable	3,267	
Short-Term Notes & Loans Receivable	515	
Long-Term Securities (note 2)	310,236	10,914
Supplies Inventory	34	
Equipment	2,362	
Accumulated Depreciation	(724)	
Intangible Assets	19	
Property Held in Trust	8,546	
Deferred Bond Issue Charges		3,939
Other Assets	8	
TOTAL ASSETS	420,391	37,622
LIABILITIES/FUND EQUITY:		
Liabilities:		
Accounts Payable	105	764
Due to Other Funds	374	1,793
Advance Deposits	15,807	
Compensated Absences	568	31
Estimated Claims Liability (note 4)	373,223	339,486
Deferred Revenue	24,089	
Bond/Notes Payable (Net) (note 5)		166,907
Arbitrage Rebate Tax Payable		34
Total Liabilities	414,166	509,015
Fund Equity:		
Contributed Capital (note 1)	12,001	
Retained Earnings:		
Unreserved	(5,776)	(485,562)
Reserved for Debt Service		14,169
Total Fund Equity	6,225	(471,393)
TOTAL LIABILITIES AND FUND EQUITY	$420,391	$ 37,622

The notes are an integral part of the financial statements.

STATE COMPENSATION INSURANCE FUND
STATEMENT OF OPERATIONS AND CHANGES IN
RETAINED EARNINGS - ENTERPRISE FUNDS
FOR THE FISCAL YEAR ENDED JUNE 30, 1994
(in thousands)

	New Fund	Old Fund
INCOME:		
Premiums (note 1)	$182,489	$ (5)
Less: Reinsurance Premium Paid (note 3)	(318)	
Safety Incentive Refunds	(545)	
Interest Earnings on Investments	13,986	1,253
Interest Earnings on Loan	96	
Other Income	84	7
Total Income	195,792	1,255
EXPENSES:		
Claims Expenses:		
Compensation Benefits	45,473	20,459
Medical Benefits	30,087	7,915
Allocated Loss Adjustment Expenses	214	364
Increase/(Decrease) in Actuarially Estimated Claims	76,678	(25,764)
Total Claims Expenses	152,452	2,974
Other Expenses:		
Operating Budget	9,090	1,691
Interest Expense		10,332
Total Other Expenses	9,090	12,023
Total Expenses	161,542	14,997
OPERATING INCOME (LOSS)	34,250	(13,742)
Gain on Sale of Fixed Assets	3	
Operating Transfers In (note 7)		42,169
Operating Transfers Out (note 7)	(2,402)	(2,383)
Net Income (Loss)	31,851	26,044
Retained Earnings - July 1, 1993	(37,627)	(497,437)
RETAINED EARNINGS - June 30, 1994	$ (5,776)	$(471,393)

The notes are an integral part of the financial statements.

STATE COMPENSATION INSURANCE FUND
STATEMENT OF CASH FLOWS - ENTERPRISE FUNDS
FOR THE FISCAL YEAR ENDED JUNE 30, 1994
(in thousands)

	New Fund	Old Fund
CASH FLOWS FROM OPERATING ACTIVITIES:		
Receipts for Sales and Services	$ 188,824	$ 7
Payments to Suppliers for Goods and Services	(3,307)	(604)
Payments to Employees	(5,508)	(1,265)
Cash Payments for Claims	(75,574)	(28,414)
Collection of Notes Receivable		2
Other Operating Revenues	53	
Net Cash Provided by (Used for) Operating Activities	104,488	(30,274)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Payment of Principle and Interest on Bonds and Notes		(33,305)
Proceeds from Issuance of Bonds and Notes		40,500
Payment of Bond Issuance Costs		(364)
Transfers to Primary Government	(3,547)	(1,286)
Transfers from Primary Government		27,167
Cash Payments for Loans	(28,266)	
Collections for Principal and Interest on Loans	43,173	
Net Cash Provided by (Used for) Noncapital Financing Activities	11,360	32,712
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Acquisition of Fixed Assets	(975)	
Proceeds from Sale of Fixed Assets	3	
Net Cash Used for Capital and Related Financing Activities	(972)	
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchasing of Investments	(274,884)	(15,918)
Proceeds from Sales or Maturities of Investments	146,612	15,641
Interest and Dividends on Investments	13,411	1,481
Net Cash Provided by (Used for) Investing Activities	(114,861)	1,204
Net Increase (Decrease) in Cash and Cash Equivalents	15	3,642
Cash and Cash Equivalents, July 1, 1993	39,308	772
Cash and Cash Equivalents, June 30, 1994	$ 39,323	$ 4,414

(Continued on page A-8)

STATE COMPENSATION INSURANCE FUND
STATEMENT OF CASH FLOWS - ENTERPRISE FUNDS
FOR THE FISCAL YEAR ENDED JUNE 30, 1994
(in thousands)

(continued from page A-7)

	New Fund	Old Fund
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Operating Income (Loss)	$ 34,250	$(13,742)
ADJUSTMENTS TO RECONCILE OPERATING INCOME TO NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES:		
Depreciation	257	
Amortization	9	
Interest Expense	1	10,403
Interest on Investments	(14,081)	(1,253)
Change in Assets and Liabilities:		
Decr (Incr) in Accounts Receivable	(16,293)	1
Decr (Incr) in Due From Other Funds	1,059	
Decr (Incr) in Inventories	34	
Decr (Incr) in Other Assets	3,332	
Incr (Decr) in Accounts Payable	26	
Incr (Decr) in Due to Other Funds	(448)	16
Incr (Decr) to Primary Government	725	
Incr (Decr) in Deferred Revenue	24,089	
Incr (Decr) in Property Held in Trust	(5,237)	
Incr (Decr) in Compensated Absences Payable	87	31
Incr (Decr) in Arbitrage Tax Payable		34
Incr (Decr) in Estimated Claims	76,678	(25,764)
Net Cash Provided by (Used for) Operating Activities	$104,488	$(30,274)
SCHEDULE OF NONCASH TRANSACTIONS		
Asset Disposals from Contributed Capital	$ (2)	
Total Noncash Transactions	$ (2)	

The notes are an integral part of the financial statements.

1. Summary of Significant Accounting Policies

Description of Business

The State Compensation Insurance Fund (State Fund) is a non-profit, independent public corporation established to allow an option for employers in the state of Montana to insure their workers' compensation and occupational disease coverage under Title 39, chapter 71 of the Montana Codes Annotated (MCA). The State Fund is governed by a five member Board of Directors appointed by the Governor. The State Fund is attached to the state of Montana, Department of Administration for administrative purposes only. Because of the Governor's appointment of the Board members and the state's regulatory oversight function, the State Fund financial statements are presented as a component unit in the state of Montana's comprehensive annual financial report.

Chapter 4, Montana Special Legislative Session, May 1990, separated the liability of the state workers' compensation insurance fund based on whether the liability arises from claims for injuries resulting from accidents that occurred before or after July 1, 1990. The legislation establishes separate funding and accounts for claims occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990 referred to as the New Fund.

The New Fund functions as an autonomous insurance fund supported solely from its own revenues. All assets, debts and obligations of the New Fund are separate and distinct from assets, debts and obligations of the state of Montana. Upon dissolution of the New Fund, any monies not needed to liquidate the New Fund would be returned to its policyholders. The State Fund administers the claims remaining in the Old Fund for the state of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of an Old Fund Liability Tax (see note 4, Old Fund). No state General Fund money is used for State Fund operations.

The State Fund records activity related to its workers' compensation insurance operations in the Enterprise Fund type. The Enterprise Funds of the State Fund are part of, but do not comprise, the entire Enterprise Fund of the state of Montana. These financial statements reflect the financial position and results of operations and cash flows of the State Fund, (New Fund and Old Fund), not the state of Montana.

Basis of Accounting

The State Fund uses the accrual basis of accounting, as defined by generally accepted accounting principles, for its workers' compensation insurance operations.

Under the accrual basis, the State Fund records revenues in the accounting period earned, if measurable; it records expenses in the period incurred, if measurable.

Cash in Treasury and Short-Term Investment Pool

Cash in treasury balances include demand deposits with the state treasury. Short-Term Investment Pool (STIP) balances are highly liquid investments with maturities of three months or less. The market value of STIP balances approximates cost.

Long-Term Securities

The State Fund invests moneys with the Montana Board of Investments, including STIP amounts. Fixed securities are stated at cost, adjusted for amortization of any discount or premium. Premiums and discounts are amortized using the straight-line method over the life of the securities. Net unrealized gains or losses on securities are not included in adjustments to retained earnings.

State Fund investments are classified in risk category 1 or risk category 2. Risk category 1 includes investments that are insured or registered, held by the state of Montana, Board of Investments or its agent in the state's name. Risk category 2 are uninsured or unregistered investments held by the counter party's trust department or its agent in the state's name.

Montana's constitution does not allow the State Fund to invest in equity securities.

Receivables

Receivables in the New Fund include accrued premiums from the fourth quarter of fiscal year 1993-94 in the amount of $43 million. The balance of the New Fund premium receivable includes amounts due for policies effective July 1, 1994 billed in advance.

Accounts receivable in the Old Fund include interest receivable and amounts due from past premiums in dispute or in collection.

Estimated uncollectible receivables are reported as an allowance for doubtful accounts.

Fixed Assets

Equipment is valued at actual or estimated historical cost. Depreciation expense is computed on a straight line basis for equipment over a period of five to ten years. All fixed assets are recorded in the New Fund. Because the State Fund administers the Old Fund, the Old Fund does not carry fixed assets. The increase in fixed assets between fiscal year 1992-93 and 1993-94 is $937,000. The majority of the increase is the purchase of additional computer hardware related to the new benefits information system.

Advance Deposits

Advance deposits are required policy holder deposits which secure payment of premiums.

Premiums

Premium rates are approved by the State Fund Board of Directors. Policies are effective July 1 until June 30, of each year. Revenue from premiums is recognized over the term of the policy year.

Effective July 1, 1994, policyholders are contractually obligated to advance certain premiums to the State Fund prior to the period the premiums are earned. Premium advances are refundable when the policyholder's coverage is cancelled and all earned premiums have been credited by the State Fund. Deferred revenue reflect amounts in advance that are received or billed but not yet earned for policies effective July 1, 1994.

Contributed Capital

Contributed capital accounts for assets transferred at the inception of the New Fund to provide the initial capitalization of the New Fund as authorized by state law and equipment

transferred from the Department of Labor and Industry upon transfer of premium audit functions to the State Fund.

Fund Equity

Fund equity consists of contributed capital and the net excess or deficit of assets over liabilities.

Basis of Presentation

The financial statements are presented in accordance with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board. State Fund insurance operations are classified in the Enterprise Fund type.

The Enterprise Fund type is used to account for operations (a) financed and operated in a manner similar to private business enterprises, where the legislature intends that the entity finance or recover costs primarily through user charges; or (b) where the legislature has decided that periodic determination of revenues earned, expenses incurred, or net income is appropriate.

2. Investments

The amortized cost and market value of the New Fund fixed maturity securities at June 30, 1994, are as follows:

June 30, 1994	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Loss	Market Value
U.S. Treasury Securities	$ 86,528,114	$ 33,611	$(3,514,325)	$ 83,047,400
U.S. Government Agencies and U.S. Government Guaranteed Securities	$ 54,747,259	$ 78,783	$(2,132,981)	$ 52,693,061
Corporate Securities	$160,934,910	$ 92,105	$(4,233,955)	$156,793,060
Other Securities	$ 8,026,264	$ 0	$(512,133)	$ 7,514,131
Total Long-Term	$310,236,547	$204,499	$(10,393,394)	$300,047,652
STIP	$ 36,802,900	$ 0	$ 0	$ 36,802,900
Totals	$347,039,447	$204,499	$(10,393,394)	$336,850,552

The amortized cost and estimated market value of fixed maturity securities at June 30, 1994, are shown below at contractual maturity. Expected maturities will differ from contractual

maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Market Value
Due one year or less	$ 36,802,900	$ 36,802,899
Due after one year through five years	165,883,044	162,104,274
Due after five years through ten years	78,304,120	73,757,069
Due after ten years	66,049,383	64,186,310
Totals	$347,039,447	$336,850,552

During fiscal year 1993-94, gross gains realized from sales of fixed maturity securities were $949,787 and gross losses realized were $786,519.

Long-term securities in the Old Fund are required debt service reserve deposits related to long term workers' compensation program bonds. Old Fund STIP balance at June 30, 1994, include $2.8 million required debt service reserve deposits for variable rate payroll tax bonds. (See note 5.) The market value of debt service reserve in the Old Fund portfolios are $10,416,515, at June 30, 1994.

All investments of the State Fund, except securities on loan, are classified in risk category 1. The New Fund and Old Fund investment portfolios include $81,505,623 and $10,913,990, respectively, in securities on loan. Securities on loan are classified as risk category 2.

3. Reinsurance

The State Fund cedes reinsurance to other insurance companies to limit the exposure arising from large losses. These arrangements consist of contracts which protect the State Fund against losses over stipulated amounts. The State Fund retains the first $1 million of each loss and $1.6 million in aggregate retention, while reinsurers are liable for losses in excess of $1 million up to a limit of $20 million on occurrences involving multiple claimants. Individual per person coverage is provided up to $2 million per claimant. In the event reinsurers are unable

to meet their obligations, the State Fund would remain liable for all losses as the reinsurance agreements do not discharge the State Fund from its primary liability to the policyholders.

Premium revenue is reduced by premiums paid for reinsurance coverage of $318,356 in fiscal year 1993-94. Reinsurance had no effect on fiscal year 1993-94 losses and loss adjustment expense.

4. Risk Management-Public Entity Risk Pools

The Old and New Funds are public entity risk pools. Neither fund had significant reductions in insurance coverage from the prior year, nor any insurance settlements exceeding insurance coverage. Unpaid claims and claim adjustment expenses are estimated based on the ultimate cost of settling the claims including the effects of inflation and other socio-economic factors.

New Fund -- Liability coverage to employers for injured employees that are insured under the Workers' Compensation and Occupational Disease Acts of Montana and workers' compensation claims occurring on or after July 1, 1990, are reported in the New Fund. The New Fund must insure any employer who desires coverage. At fiscal year-end 1993-94 approximately 26,100 employers were insured with the New Fund. Anticipated investment income is considered for computing a premium deficiency and employers must pay premiums to the State Fund within specified time frames.

An actuarial study prepared by Tillinghast, a Towers Perrin company, for the New Fund as of June 30, 1994 estimated liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors.

A provision for inflation and the calculation of estimated future claim costs is implicit in the calculation because reliance is placed both on actual historical data that reflect past inflation and on other factors that are considered to be appropriate modifiers of past experience. At June 30, 1994, $509,019,962 of unpaid claims and claim adjustment expenses are presented at

their net present value of $373,223,095. These claims are discounted at an annual rate of 5.75 percent. When the New Fund purchases annuity contracts, the claim is settled in full and on a final basis and all liability of the New Fund is terminated.

State law requires the New Fund to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. State law also requires the State Fund to establish a surplus balance of 25 percent of annual premium revenue by July 1, 2003.

Old Fund -- The liability and payment of workers' compensation claims for incidents occurring before July 1, 1990, are reported in the Old Fund. There is no premium income; however, funding for claims payments is provided by old fund liability taxes (OFLT) imposed on employers' payroll (0.5 percent), employees' wages (0.2 percent), and sole proprietors' and subchapter S shareholders' distributive income (0.1 percent). The OFLT for sole proprietors and shareholders increased to 0.2 percent beginning January 1, 1994. The OFLT is to provide funding for Old Fund claims expenses and Old Fund bond payments (see note 5). An actuarial study prepared by Tillinghast, a Towers Perrin company, for the Old Fund as of June 30, 1994, was used to estimate liabilities and the ultimate cost of settling claims that have been reported but not settled and claims that have been incurred but not reported. At June 30, 1994, $339,485,647 of unpaid claims and claim adjustment expenses are presented at face value. Total Old Fund deficit at June 30, 1994 is $471,393,590. This fund does not discount estimated claims liability.

Changes in Claims Liabilities for the Past Two Years

The following table presents changes (in thousands) in the aggregate liabilities for the New Fund and the Old Fund for the past two years. The information presented has not been discounted.

Table 1

Changes in Claims Liabilities
(in thousands)

Component Units	STATE COMPENSATION INSURANCE (NEW FUND) 1994	1993	STATE COMPENSATION INSURANCE (OLD FUND) 1994	1993
Unpaid claims and claim adjustment expenses at beginning of year	$404,706	$291,402	$365,249	$406,719
Insured claims and claim adjustment expenses:				
Provision for insured events of the current year	184,039	170,792		
Increase (decrease) in provision for insured events of prior years	(3,952)	14,422	2,975	7,500
Total incurred claims and claim adjustment expenses	180,087	185,214	2,975	7,500
Payments:				
Claims and claim adjustment expenses attributable to insured events of the current year	(18,693)	(19,087)		
Claims and claim adjustment expenses attributable to insured events of prior years	(57,080)	(52,823)	(28,739)	(48,970)
Total payments	(75,773)	(71,910)	(28,739)	(48,970)
Total unpaid claims and claim adjustment expenses at end of the year	$509,020	$404,706	$339,485	$365,249

Risk Management Trend Information

The following table illustrates how the earned revenues of the New Fund plus investment income compare to related costs of loss and other expenses assumed by the State Fund for fiscal years 1991 through 1994. In addition, cumulative amounts related to estimated and actual paid claims are presented. The information allows for comparison of actual and estimated claims and is a basis for developing revenue and claims information. As data for individual policy years mature, the correlation between original estimates and re-estimated amounts is used to evaluate the accuracy of incurred claims currently recognized for less mature policy years.

Table 2

STATE COMPENSATION INSURANCE (NEW FUND)
(in thousands)

	1991	1992	1993	1994
1. Net earned required contribution and investment revenues	$105,542	$132,423	$179,359	$184,412
2. Unallocated expenses including overhead	6,048	8,232	9,325	9,090
3. Estimated incurred claims and expenses, end of policy year	137,237	183,425	186,480	199,890
4. Paid (cumulative) as of:				
End of policy year	17,618	20,244	18,347	18,693
One year later	44,335	50,576	46,343	
Two years later	64,079	68,837		
Three years later	74,901			
5. Reestimated incurred claims and expenses:				
End of policy year	137,237	183,425	186,480	199,890
One year later	166,980	184,968	184,030	
Two years later	160,272	175,218		
Three years later	151,554			
6. Increase (decrease) in estimated incurred claims and expenses from end of policy year	14,317	(8,207)	(2,450)	

5. Payroll Tax Bonds (Workers' Compensation Program)

The Board of Investments of the state of Montana issued $142,095,000 of bonds in July 1991 for the purpose of funding the state's liability and costs in administering and paying claims for injuries resulting from accidents, prior to July 1, 1990, that are subject to the Montana Workers' Compensation Act and the Occupational Disease Act of Montana. The bonds bear interest at rates from 4.9 to 6.875 percent, and are limited obligations of the state of Montana payable solely from and secured by certain Old Fund liability tax revenues collected by the Department of Revenue of the state of Montana. Amounts of bond debt outstanding at June 30, 1994 are shown below (in thousands).

Bonds Outstanding June 30, 1994	Discount	Net Bond Debt June 30, 1994
$136,265	$1,858	$134,407

Debt service requirements for principal and interest are as follows (in thousands):

Fiscal Year	Debt Service Payments
1994-95	11,318
1995-96	11,321
1996-97	11,318
1997-98	11,318
1998-99	11,318
1999+	237,722
Totals	$294,315

On October 27, 1993, the Board of Investments issued $32,500,000 in Variable Rate Payroll Tax Bonds (Workers' Compensation Program Series 1993) to pay the costs associated with claims incurred on or before June 30, 1990. The Series 1993 Bonds are limited obligations of the state of Montana, payable solely from and secured by certain Old Fund liability tax revenues. Bond proceeds were used to repay $21,321,007 in loan principal and interest to the New Fund and the remaining proceeds after issuance costs of $7,962,247 were pledged to meet Old Fund claims costs. The variable rate bonds pay interest determined on a weekly period established by a remarketing agent. The variable rate bonds are subject to redemption at the discretion of the Board of Investments during the period variable rates are applied on the bonds. The bonds are payable June 1, 2020, unless terminated at an earlier date upon certain occurrences. In fiscal year 1993-94, $601,827 in interest payments and fees were paid on the variable rate bonds.

6. Administrative Cost Allocation

State law requires the State Fund to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (New Fund). The law also limits annual administrative costs of claims associated with the Old Fund to $3 million. The State Fund allocated $2.9 million in administrative costs to the Old Fund in fiscal year 1993-94.

7. Transfers

Operating transfers out of the New Fund include transfers to the Department of Labor and Industry for regulatory administrative assessments charged to the State Fund.

Operating transfers in recorded for the Old Fund include $41 million in fiscal year 1993-94 of Old Fund liability tax (OFLT) revenue collected by the state of Montana Department of Revenue (see note 4). Operating transfers out of the Old Fund include administrative costs.

8. Compensated Absences

Employees at the State Fund accumulate both annual and sick leave. The State Fund pays employees for 100 percent of unused annual leave and 25 percent of unused sick leave upon termination. The fund pays 100 percent of unused compensatory leave credits upon termination to nonexempt employees. The State Fund absorbs expenditures for termination pay in its annual operational costs. The State Fund had a total leave liability of $598,092 at June 30, 1994.

9. Pension Plan

The State Fund and its employees contribute to the Public Employees' Retirement System (PERS), a cost sharing, multiple employer, defined benefit pension plan. Established in 1945 and governed by Title 19, chapter 3, MCA, PERS participants are eligible to retire at age 60 with at least five years of service, at age 65 regardless of length of service or at 30 years of service regardless of age. A reduced retirement benefit may be taken with 25 years of service or at age 50 with a minimum of five years of service. Monthly retirement benefits are calculated by taking 1/56 times the years of service times the final average monthly salary. Vesting occurs once membership service totals five years. State Fund and its employees each were required to contribute 6.7 percent of annual compensation in fiscal year 1993-94.

As of June 30, 1994, there were 249.75 State Fund full-time equivalents (FTE) covered by PERS. State Fund covered payroll was $5,219,689 and PERS contributions were $434,174 in fiscal year 1993-94.

Actuarial valuations are performed at PERS every two years. The latest valuation was performed as of July 1, 1994. In calculating the pension benefit obligation, the actuary assumed a return on investments of 8 percent, salary inflation increases of 6.25 percent and no change in post retirement benefits.

The "pension benefit obligation" is a standardized disclosure measure of the present value of pension benefits, adjusted for the effects of projected salary increases and step-rate benefits, estimated to be payable in the future as a result of employee service to date. The measure, which is the actuarial present value of credited projected benefits, is intended to help users assess the system's funding status on a going-concern basis, assess progress made in accumulating sufficient assets to pay benefits when due and make comparisons among employers. The State Fund is unable to determine the actuarial present value of credited projected benefits and net assets available for benefits since the information is available only on a total state basis, not agency basis.

The pension benefit obligation at June 30, 1994, for PERS as a whole was $1,475,985,705. The system's net assets available for benefits at cost on June 30, 1994, were $1,202,063,252 leaving an overall unfunded pension benefit obligation of $273,922,453. The State Fund's 1994 contribution represented approximately 1.1 percent of total June 30, 1994 contributions required of all participating entities. The State Fund is not responsible for any state system unfunded liability.

Ten-year historical trend information showing the PERS progress in accumulating sufficient assets to pay benefits when due is presented in the PERS June 30, 1994, annual financial report.

10. Building

The 1981 Legislature appropriated funds for the construction of a Workers' Compensation building. State Fund expenses annual payments on the building in its operating budget. As of July 1, 1990, the State Fund transferred the value of the building from its records to the Department of Administration, which owns most other state buildings and charges agencies rent for their use. Under the agreement, the State Fund will pay all costs

associated with the building, including utilities, debt service, property taxes, janitorial services, and maintenance in lieu of paying rent.

11. Subsequent Event

A class action was filed before the Workers' Compensation Court in Murer, et al. vs. Montana State Compensation Mutual Insurance Fund, et al., which attempts to have the Court rule that a freeze on workers' compensation benefits in place in fiscal years 1988 through 1991 should no longer apply once the date of the freeze expired. The State Fund's position is that the law in existence at the time of the injury applies for the life of the claim. The case was rejected by the Workers' Compensation Court as a class action and that decision was affirmed by the Montana Supreme Court. The case was then set before the Workers' Compensation Court and included only named claimants and insurers. Though not a class action, an adverse decision will have the same impact. The Workers' Compensation Court rejected the case and it was appealed to the Montana Supreme Court. On November 21, 1994, the Montana Supreme Court reversed the decision of the Workers' Compensation Court. The estimated amount of loss has been previously estimated as lesser amounts up to $11,000,000. Management believes the ruling will have a material impact on the New Fund and the Old Fund, however, this case is subject to a pending rehearing request before the Montana Supreme Court and then a hearing on remand before the Workers' Compensation Court to rule on issues so that claims eligible for recovery can be fully determined. As a result, an estimate of actual loss incurred cannot be determined until the State Fund receives final decisions on this matter.

Agency Response

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7 1994
LEGISLATIVE AUDITOR

December 6, 1994

Scott A. Seacat
Legislative Auditor
Room 135
State Capitol Building
Helena, MT 59620

Subject: State Compensation Insurance Fund's Financial Compliance Audit for Fiscal Year 1993-94

I would like to convey my thanks to your staff for their effort and cooperation during this audit. We appreciate the thoroughness of their work. Even though no formal recommendations were made as a result of this audit, the State Fund's management remains open to suggestions for continued improvement of its fiscal operations.

Thank You!

Sincerely,

Carl W. Swanson
President

cc: Rick Hill, Chairman of the Board

Benefits Department 1-800-332-6102 • First Report of Accident 1-800-243-9121 • Underwriting Department 1-800-336-8968
Fraud Hotline 1-800-922-2873 • Loss Prevention/Premium Audit (406) 444-6584 • TDD (406) 444-5971